DOW THEORY LETTERS INC.

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EXPLANATION OF THE CHART OF AVERAGES AND INDICATORS WHICH APPEARS IN DOW THEORY LETTERS

Dow Theory Letters was one of the first investment services to offer a comprehensive continuously up-dated chart of the leading market averages and indicators. This feature was started in February, 1962, but later dropped because of technical difficulties related to printing and maintaining the chart. Many subscribers expressed keen disappointment at this omission. After a long lapse, during which the writer experimented with numerous types of graphs and reproduction equipment, the valuable indicator chart was again incorporated as a regular feature of Dow Theory Letters.

Note that of the sixteen indicators which appear on the chart, three are directly related to price. These are the Dow Jones Industrial Average, the Standard & Poor 425 Industrial Average and Barron's Low-Priced Stock Index.

Five of the indicators are indirectly related to price but are more correctly referred to as breadth indicators. These are the daily Advance-Decline Ratio, the 10-day Average of Daily Advances and the 10-day Average of Daily Declines, the 5-day Average of Daily New Highs and the 5-day Average of Daily New Lows, the Percentage of 89 Stock Groups holding above their moving averages and the Percentage of 432 Stocks holding above their moving averages.

The rest of the indicators can more or less be related to market psychology. Since the market fluctuates in response to changes in human psychology, these "psychological indicators" (perhaps more than any others) contain elements of true predictive value. Price and breadth tell us where we are and how we are doing; psychology measurements tell us where we are liable to be a month or a few months from now.

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The D-J Industrial Average is composed of 30 of the largest corporations in the nation. The D-J stocks are all investment-grade issues, and the D-J Average is supposed to measure investment (as opposed to speculative) sentiment. This is the most widely followed of all the market indicators.

The Standard & Poor 425 Industrial Stock Average is a much more comprehensive Average than the Dow and is a much broader gauge of general Industrial prices. Note on the chart that the 425 has been superimposed upon the Dow — and for a reason; at times the 425 will outperform the Dow, and this "disparity" is usually bullish. Past history indicates that the Dow will usually catch up with the 425 when the disparity is in favor of the latter. The converse is true when the 425 lags behind the Dow, and this type of disparity is generally considered bearish.

The daily Advance-Decline Ratio is fully explained in the booklet "Basic Technical Theory" (which is available to all subscribers) and will not be discussed here.

The 10-day Average of Advances and the 10-day Average of Declines act together as "buying power" and "selling pressure" indicators. Whenever the advance line is above the decline line it means that over the past 10 days there have been more advances than declines or that "the buyers have been more powerful than the sellers." The converse is true when the decline (dotted) line is above the advance (solid) line. It is a characteristic of these two lines that they continually criss-cross. As an approximate rule, when the advance line is around 6500 or more, the market is overbought and ready to react. When the decline line is around 6500 or more, the market is oversold and ready to react.

Odd-lot transactions were discussed in the Basic Technical Theory booklet. The indicator pictured on the chart is a 10-day average of the daily odd-lot ratios (daily ratios are obtained by dividing daily odd-lot sales by daily odd-lot purchases). When the indicator rises, it means that odd-lotters are moving towards less selling or to more buying. When the line moves down, odd-lotters are moving to less buying or to increased selling. Solid black areas on chart represent periods of actual net selling.

The Odd-lot Short Ratio is a 5-day average of daily odd-lot short sales divided by daily odd-lot sales. This indicator rises as the intensity of odd-lot shorting increases. The odd-lot short seller tends to be least active near important tops (when he should be most active) and most active near important bottoms (when, of course, he should be least active).

The Short Interest Ratio is fully explained in the Basic Technical Theory booklet.

Barron's Confidence Index (C.I.) is the ratio of the yield on the broad D-J 40 Bond Average and the yield on Barron's 10 Highest Grade Bond Average. When sophisticated bond buyers become confident, they tend to foresake safety and quality (as represented by Barron's 10 Highest Grade Bonds) in favor of higher yields (as represented by the D-J 40 Bonds). When this change in sentiment occurs, the C.I. rises. The converse is true when bond buyers are bearish and are willing to forego higher yields in favor of safety. Since bond buyers are supposed to be "better informed" than stock buyers, the movements of the C.I. are supposed to (and often do) precede movements in the D-J Industrial Average.

Barron's Business Index is one of the oldest and best known of the many business and production indices. Barron's Index is a true heavy goods gauge in that it measures "the stuff that counts" — the big factors which make for recessions or booms. Components of Barron's Index include steel and coal production, petroleum and electric power output and rail carloadings. The index is properly adjusted for seasonal, population and long-term growth trends.

The Percentage of 89 Standard & Poor Stock Groups holding above their moving averages and the Percentage of 432 (representative) Stocks holding above their moving averages are two valuable breadth studies and may be used as confirmatory indicators in conjunction with the advance-decline ratio. Statistics for these two indicators are tabulated by the writer each week. As a rule, when these two indexes hold above the 50% level, the situation is considered to be hopeful to bullish. The converse is true when these two indexes drop below the critical 50% level.

The Debit Balances measure the total amount of margin loans outstanding on the N. Y. S. E. It is well to remember that the professional speculator (as opposed to the amateur "investor") is generally the one who makes use of a margin account. One of the most bullish indications during a broad advance is a steady rise in debits (margins). This means that the professional speculator is using his most important tool (i.e., his margin) and continuing to expand his line of stocks. Eventually, debits will turn down. From that point on, the rise can be considered to be on borrowed time, and it is then up to the public to "carry the ball." When debits decline, the inference is that the professional speculator is moving toward the exits.

Credit Balances are the cash totals in customers' accounts. Whereas the professional (above) tends to use margin, the public not only avoids margin but actually tends to keep sundry amounts of cash in its accounts. A rise in credit balances indicates that the public is selling stock and building up cash in its accounts; the converse is true when credit balances are declining. As a rule, rising credit balances during an advance (i.e., public is selling stocks and building up cash while the market is rising) may be considered bullish, while declining credits during an advance suggest danger (public is buying stocks and becoming increasingly bullish as the market advances).

The debit and credit balances are best examined together. For instance, when, during a rise, debits and credits are rising implications are bullish for then we know that the professional is adding to his (margin) account while at the same time the public is (selling stocks) and thereby adding to its cash account. On the other hand, when both indicators are declining during a rise, the implications are negative, and such situations (even though the rise continues) are usually accompanied by extremely selective markets.

During a major bear market, it is normal to see debits drop lower and lower until near the end of the bear market, debit balances are at or below the levels which were in effect when the previous bull market began. The implication here is that the bear market has at last "beaten" the professional speculator — he has finally left the market and has no further use for his margin account.

Note: The last two indicators, the debit balances and credit balances, are two of the least known of the indicators. The first serious work on the subject was offered by my friend, Dr. Sloan Wilson of Kansas. His book, Public Participation in the Stock Market, is an excellent treatise on the credit balances, and his second book, The Speculator and the Stock Market, is an equally scholarly work on the debit balances. Both of these volumes are available at this office.

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